DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 03-0213
Gross Income Tax
For the Years 1998, 1999, and 2000

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ISSUE

I. Gross Income Tax—Small Business Exemption

Authority: IC 6-8.1-5-1(b); IC 6-2.1-2-2; IC 6-2.1-3-24.5; IRC § 1361.

Taxpayer protest the imposition of gross income tax upon Taxpayer's subsidiaries.

II. Gross Income Tax—Proceeds from Real Estate Property Sale

Authority: IC 6-2.1-1-2(c)(1); IC 6-2.1-3-16; IC 14-34-1-3; IC 14-34-3-1; IC 14-34-3-12; IC 14-34-6-1; IC 14-34-6-13; IC 6-2.1-1-2(b); 45 IAC 1.1-2-19(b); Department of Revenue v. 1 Stop Auto Sales, Inc., 810 N.E.2d 686 (Ind. 2004); Cambria Iron Co., v. Union Trust Co., 154 Ind. 291, 55 N.E. 745 (1899)

Taxpayer protests the disallowance by the Department of a reduction of gross income tax to reflect mortgage and reclamation liabilities.

III. Gross Income Tax—Receipts from sales in brokerage or agency agreements

Authority: Department of the Treasury v. Ice Service, Inc., 41 N.E.2d 201 (Ind. 1942); (Ind. Tax 2002); Policy Mgmt. Sys. Corp. v. Department of State Revenue, 720 N.E.2d 20 (Ind. Tax 1999).

Taxpayer protests the assessment of gross income tax on the entire amount paid to it for the sale of coal—instead of gross income tax assessed only on the markup paid to it.

IV. Tax Administration—Penalty

Authority: IC 6-8.1-10-2.1(a)(3); IC 6-8.1-10-2.1(b); 45 IAC 15-11-2(b) and (c).

Taxpayer protests the imposition of a 10% negligence penalty.

STATEMENT OF FACTS

Taxpayer includes a parent holding company and two subsidiaries. The subsidiary filed on a consolidated basis with Parent. The Department conducted an audit of Taxpayer's Indiana operations. Proposed assessments of additional gross income tax, interest, and penalties were issued.

I. Gross Income Tax—Small Business Exemption

DISCUSSION

All tax assessments are presumed to be accurate; the taxpayer bears the burden of proving that an assessment is incorrect. IC 6-8.1-5-1(b). IC 6-2.1-2-2 [repealed effective January 1, 2003] imposed a gross income tax on the receipt of the entire taxable gross income of a resident or domiciled Indiana taxpayer. However, under IC 6-2.1-3-24.5(b), a corporation which qualifies as a small business corporation was exempt from Gross Income Tax. IC 6-2.1-3-24.5(a) stated that for Gross Income Tax purposes, a small business corporation has the same definition as given in I.R.C. § 1361(b).

Taxpayer Parent qualified as a small business corporation within the statutory definition of I.R.C. § 1361(b)(1). However, Taxpayer Parent was not an S-corporation because Taxpayer Parent terminated its Subchapter S election effective January 1, 1998 and became a C-corporation.

The Taxpayer Subsidiaries were not small business corporations due because Taxpayer Subsidiaries had a C-corporation shareholder, Taxpayer Parent. IRC § 1361(b)(1)(B). This rendered the Taxpayer Subsidiaries ineligible for I.R.C. § 1361(b) small business corporation status.

Taxpayer Parent maintains that because it was eligible for S-corporation treatment within I.R.C. § 1361(b), Taxpayer Subsidiaries were eligible for S-corporation treatment by virtue of I.R.C. 1361(b)(3)—which provides that domestic corporations wholly owned by an S-corporation are disregarded as a separate entity and are treated as part of the parent S-corporation for tax purposes. Such status required Taxpayer Parent to elect to be treated as an S-corporation—which Taxpayer Parent terminated effective January 1, 1998. The effect of this is: (1) Taxpayer Subsidiaries were not small business corporations within the meaning of the statute; (2) Gross income tax may be assessed.

FINDING

For the reasons discussed above, the Department denied Taxpayer's protest.

II. Gross Income Tax—Proceeds from Real Estate Property Sale

DISCUSSION

Taxpayer sold one of its coal mines. Receipts from the sale were used to pay off collateralized lines of credit. In addition, the purchaser of the mine assumed the reclamation liability.

IC 6-2.1-3-16 stated that amounts received from sales of real estate are exempt from gross income tax to the extent a mortgage or similar encumbrance exists on the real estate at the time of its sale. 45 IAC 1.1-2-19(b) stated:

> (b) The amount of any receipts that represent a mortgage or similar encumbrance, but not any interest due thereon, that exists on real estate at the time of its sale is exempt from the gross income tax under the following circumstances:
> (1) The mortgage is paid off as a result of the sale.
> (2) The mortgage is assumed by the purchaser.
> (3) The property is transferred subject to the mortgage.
> …

Here the amount that Taxpayer received was used to pay off a debt secured not only by real estate, but also by items of tangible personal property and by other executed instruments. Given IC 6-2.1-3-16 is an exemption statute strictly construed against Taxpayer, the amounts in question first must be construed as paying off items other than the real estate, then the real estate. Taxpayer has not provided sufficient documentation to establish that the payoff was greater than the value of the tangible personal property and other instruments the Taxpayer provided as security; and accordingly is denied with respect to this issue.

The property was transferred subject to the reclamation liability. The Indiana General Assembly has promulgated in IC 14-34 statutes regulating surface coal mining and reclamation. The statutes extend the requirements of the federal Surface Mining Control and Reclamation Act of 1977. *See* IC 14-34-1-3. Surface mining of coal is permitted only if a valid reclamation permit is secured. *See* IC 14-34-3-1. IC 14-34-3-12 requires that a reclamation plan be developed and submitted with the reclamation permit. IC 14-34-6-1 requires that a bond for performance be posted with the state; additional bonds are to be filed to cover additional reclamation costs due to continued mining. The reclamation bond is released upon the successful completion of reclamation. IC 14-34-6-13. The effect of these statutes is to ensure that the reclamation of the land is performed. The bond provides insurance—if the mining company does not reclaim the land, the bond will provide the necessary funds to reclaim the land.

Those who mine coal are required to rehabilitate the land after enjoying the mineral interest. Reclamation is a cost of doing business. IC 6-2.1-1-2(b) stated, that in general, no deduction from a taxpayer's gross income may be taken for return of capital invested, cost of property sold, cost of materials used, labor costs, interest, discounts, commissions paid or credited, losses, or any other expense paid or credited. The Indiana Supreme Court has stated that "ambiguous exemption statutes are to be strictly construed against the taxpayer." Department of Revenue v. 1 Stop Auto Sales, Inc., 810 N.E.2d 686, 689 (Ind. 2004). The Indiana Supreme Court also has stated that a party cannot have the benefits without the burdens. *See* Cambria Iron Co., v. Union Trust Co., 154 Ind. 291, 301-02; 55 N.E. 745, 749 (1899). Reclamation is a requirement of law and no statute allows an exemption of those costs from inclusion as taxable gross income.

FINDING

For the reason discussed above, the Department denies Taxpayer's protest.

III. Gross Income Tax—Receipts from sales in brokerage or agency agreements

DISCUSSION

Upon the sale of the mine, Taxpayer entered into an agreement with the purchaser to supply coal to two of Taxpayer's customers. These customers had entered into long-term coal supply agreements with Taxpayer when it owned the mine. Taxpayer invoiced the customer for the coal supplied by Producer. The customer remitted its payment to Taxpayer, who then paid Producer for the coal. Taxpayer kept an amount of the payment for itself.

The Indiana Supreme Court in Department of the Treasury v. Ice Service, Inc., 41 N.E.2d 201 (Ind. 1942) examined an agency relationship as it relates to gross income tax. The court stated that the question of whether an agency relationship exists is ordinarily a question of fact, which may be established by direct or circumstantial evidence. *Id*. at 203. The creation of the agency relationship will depend upon the intention of the parties. *Id*. The court in Ice Service used a flexible interpretation of agency relationship to encompass the parties' business agreement. Taxpayers are not subject to gross income tax on income they receive in an agency capacity. *See* Policy Mgmt. Sys. Corp. v. Department of State Revenue, 720 N.E.2d 20, 23 (Ind. Tax 1999). Before a taxpayer may deduct income received in an agency capacity, two requirements must be met:

> (1) the taxpayer must be a true agent, and
> (2) the agent must have no right, title, or interest in the money or property received or transferred as an agent.

Id. A taxpayer is not subject to gross income tax on receipts received on behalf of a third person. *Id*.

In this case, the agreement signed between Taxpayer (Seller) and Producer states that title and risk of loss passes from Producer to Seller (Taxpayer), FOB Mines. Given that the coal is shipped directly to customers, the intent of the parties needs to be determined. In Ice Services, the court stated that it will ignore apparently inconsistent language and look to the real nature of the agreement between the parties: (*i.e.* what is the real purpose of the agreement and from the nature of the transaction, what must be in the minds of the parties). At the hearing, Taxpayer could not explain why the coal selling agreement stated that Taxpayer takes title to the coal. The Department confirmed that Taxpayer and Producer are true third-parties and is satisfied that the coal selling agreement is an arms-length transaction because there were no common business owners between Taxpayer and Producer.

The second requirement of agency named in Policy Mgmt. Sys. Corp. states that the agent must have no title in the property transferred as an agent. The coal selling agreement stated that title passes to Taxpayer. Taxpayer stated at the hearing that it earned a commission of only $0.50 per ton. The Department noted this and investigated the agreements between Taxpayer and Producer

and the agreements between Taxpayer and customers. While the use of the term agent need not be stated for an agency relationship to exist, other evidence of the relationship will prove agency. But no such evidence has been found.

The audit report stated that when Taxpayer sold the mine to Producer under the pre-existing contracts, Taxpayer was still obligated to provide coal to certain customers in 1999 and 2000. Taxpayer stated it began brokering coal from Producer to meet those contractual obligations.

A reading of the original contracts between Taxpayer and its customers stated that the coal to be supplied is to be provided from a specific mine. The contracts indicated that the owner of the mine is not the seller of the coal. In those contracts, the owner of the mine is named as Taxpayer's Subsidiary 1 and the seller of the coal is named as Taxpayer's Subsidiary 2. So, in effect, while the revenues ended up in the pocket of Taxpayer (the parent holding company) the mine was owned by one subsidiary and the coal was sold by another subsidiary. When the mine was sold, it did not change the fact that Subsidiary 2 (the sales subsidiary) was still obligated to make good on the agreements, despite the fact that Subsidiary 1 (the owner subsidiary) no longer controlled and operated the mine.

When the mine was sold, the contracts to supply the customers could have undergone novation—substituting Producer for Taxpayer. But this did not occur. Taxpayer's Subsidiary 2 remained obligated to see that coal was supplied to the customers. This explains why the contract between Taxpayer and Producer stated that title passes to Taxpayer. The whole effect of the arrangement is that Taxpayer continued to supply coal to the customers. Taxpayer and Producer made an agreement which allowed Taxpayer to continue to receive coal supplies to sell to the customers. Taxpayer did not receive commissions for brokering; Taxpayer received coal supplies from Producer and their agreement fixed the markup margins. Taxpayer was not acting as an agent for Producer; Taxpayer was continuing the business of Subsidiary 2 despite the fact that Subsidiary 1 no longer had a mine to supply coal.

FINDING

For the reasons stated above, the Department denies Taxpayer's protest.

IV. Tax Administration—Penalty

DISCUSSION

When the Department issued the assessments, it imposed a 10% negligence penalty. Taxpayer protested the imposition of the penalty. IC 6-8.1-10-2.1(a)(3) states that if a person is examined by the Department and incurs a deficiency that is due to negligence, the person is subject to a penalty. In general, the penalty is 10%. *See* IC 6-8.1-10-2.1(b). 45 IAC 15-11-2(b), states:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to reach and follow instructions

> provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

45 IAC 15-11-2(c) provides in pertinent part:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

Under 45 IAC 15-11-2(b), Taxpayer incurred a deficiency which the Department determined was due to negligence and will be subject to a penalty under IC 6-8.1-10-2.1(a). In its protest letter, Taxpayer requested a waiver of penalties—but provided no documentation to establish reasonable cause. Taxpayer supplied no affirmative explanation to the Department in its letter. At the hearing, Taxpayer provided no affirmative explanation to establish reasonable cause. Since, Taxpayer has not affirmatively established that its failure to pay the deficiency was attributed to reasonable cause and not negligence, as required by 45 IAC 15-11-2(c), the Department will impose the 10% negligence penalty.

FINDING

For the reasons stated above, Taxpayer's protest is denied.

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